SOME FREQUENTLY NEGLECTED FACTORS IN THE INCIDENCE OF TAXATION

It is a commonplace of the theory of incidence that taxes on commodities which are competitively produced under conditions of constant cost rest ultimately on the consumers. But the assertion that taxes on commodities are paid by consumers in proportion to the quantities of taxed goods consumed by them does not mean, unless substantially all commodities are taxed, that the burden of taxation gets distributed among these consumers in proportion to their total expenditures, still less in any sort of proportion to their ability to spend. Thus, suppose commodity taxes to be levied only upon tobacco. Then they would be paid, in the last analysis, solely by tobacco users, who would thus be *discriminated against as compared with the rest of the community.* It used sometimes to be remarked by economists that "an old tax is a just tax," the theory being that in time men change their investments or their particular lines of work and thereby cause prices to become so adjusted as to distribute an old tax evenly. Thus, a tax on tobacco would cause a rise in the price of tobacco sufficient to keep labor and capital from withdrawing entirely or anything like entirely from the tobacco business. But it is to be noted that, so far as the *consumers* of tobacco are concerned, no such shifting of the burden is possible. Tobacco consumers are not in any one business but in all kinds of business. Even if they were, by chance, all in one kind of business, they could not avoid the tax by changing to some other business, but only by ceasing to purchase tobacco. And what is true of a tax on tobacco is true in varying degrees of a tax on any commodity or small group of commodities. For even if the tax is levied on an article consumed by all, there is no reason to suppose that the consumption of such an article will be necessarily in proportion to general consumption or to income.

It must not be supposed that, when one or a few commodities are taxed, consumers will be compensated for the increased prices

of the taxed goods by any reduction of the prices of other goods to the production of which the tax-displaced labor and capital are turned. For the labor and capital set free by the higher prices of and the consequent decreased demand for the taxed goods (or by the decreased buying of other goods in order to satisfy an inelastic demand for the goods taxed) will presumably be employed in producing the goods and services which the government buys with the revenue that the taxes yield. The tax diminishes the buying power of the individual; but it increases the buying power of the government.

The discussion leads naturally, at this point, into a consideration of the effect of taxation of commodities upon the general price-level. The increased price of any commodity due to a tax would probably, in practice, be so included in most index numbers as to make it appear that average prices were raised by such taxation. Yet in fact a price increase due to a tax is not properly a rise in the price of the commodity in question as a commodity. The tax is really paid for *additional* goods or services which are rendered by the government. In the process of buying the commodity and at the moment of purchase the buyer also pays for a government service. Without necessarily thereby subscribing to any "purchase" theory of taxation, we may nevertheless assert that the part of the so-called price of a taxed commodity which constitutes the tax might more properly be regarded, when the community is collectively considered, as the price of the government service or services for which it is levied. If an exactly equal tax were paid directly from income independently of any purchase, it would not be included in an index number of prices. If, then, a part of the income is turned over to the government on the occasion of the making of a purchase, the transaction may be logically regarded in the same way. In other words, taxation of commodities does not raise the price of the commodities *as such*, and high prices, so far as they are due to commodity taxation or its equivalent, ought to be sharply distinguished from high prices which result from money or credit inflation. Thus, an argument that wages or salaries should be raised because prices had risen might have much greater validity if the rise of prices had resulted from

inflation than if it had resulted from taxation of commodities. In the latter case the implication would be that the recipients of wages and salaries should be relieved, at the expense of their employers or of others, of the burden of taxes on commodities which the rest of the community had to pay.

There is another, though perhaps a minor, aspect of the problem of taxation in relation to average prices which is worth a moment's attention. Taxes on commodities, so far as they are shifted to consumers, involve the passing through several hands of the money which government requires. Thus government may collect from a manufacturer. The manufacturer reimburses himself by collecting from the wholesaler, the wholesaler by collecting from the retailer, and the retailer by collecting from the consumer. The indirect nature of the payment to government as compared with a direct payment from consumer to government means that the tax money, during its indirect passage from consumer to government is, in effect, temporarily taken out of circulation. This money is thus prevented from acting on prices as quickly and effectively as if it were paid directly to government by consumer and then spent by government. The several stages in the collection operate as increased trade transactions, and so, according to the quantity theory of money, tend to lower *average* prices, although the *taxed* goods are made higher in price by the tax. On the other hand, so far as a tax, by diverting producers out of a line in which their efficiency is highest, decreases the volume of goods produced, it operates to raise average prices.

Taxation of commodities burdens consumers the more exactly in proportion to their general consumption, the larger the number of consumable goods and services which are taxed and the more nearly these goods are taxed at the same ad valorem rate. Taxes on consumable goods lessen real incomes by raising prices. Taxes levied directly on incomes decrease directly the ability of consumers to purchase goods. But some persons accumulate capital by saving while others dissipate it by spending. Hence taxes on consumable goods would not be distributed either during any short period or in the long run in the same proportions among persons and classes as would taxes on money incomes.

It is generally recognized that taxes on commodities may, under certain circumstances, fall in part upon other persons than the consumers of the taxed commodities. Thus, such taxes may fall upon the economic rent of land used in the production of the goods, upon the return to the owners of capital in case the capital is immobile, upon entrepreneurs' profits, or upon wages. In the case of economic rent this fact has long been recognized. At a price higher by the full amount of the tax, demand for the commodity decreases. The amount sold cannot be the same as it would be without the tax unless the price is the same. The producer on the no-rent margin—if himself marginal between this and some other business—cannot or will not pay the tax and continue to produce the commodity. Marginal land used for the purpose will cease to be used. Other land will be used less intensively. But if demand is elastic and most of the supply is produced under conditions much more favorable than those at the margin, competition will prevent the price from rising as much as the tax and will force a reduction of rents. But the mere coexistence of elastic demand with production on land of different qualities (or of diminishing returns with more intensive use of land) will not of itself cause any appreciable part of the tax to fall upon economic rent. For land which is so far superior to marginal or no-rent land that its abandonment is almost unthinkable may nevertheless be so nearly as good for some other use that any potentially decreased return whatever to its owner, resulting from the tax, would cause it to be diverted to such other use. In order, therefore, that a tax on commodity should fall on economic rent, the following conditions must be coexistent: an elastic demand for the commodity; production on different grades of land or, if the land is all of the same grade, under conditions of diminishing returns with more intensive production; absence, as regards at least part, or, perhaps, most, of the land used, of alternative uses profitable enough so that the burden of the tax might make these other uses relatively desirable. It is probable that most economists are really aware of the necessity for the coexistence of all these conditions, but the conditions are not all ordinarily mentioned in current texts and discussions on the theory of incidence.

A tax on a commodity produced under the direction of entrepreneurs of widely different versatility may also fail to be shifted entirely upon consumers. In this case it may fall in part upon the entrepreneurs engaged in producing the taxed commodity. Those of the producers who can turn without appreciable loss in efficiency to other lines of production may do so. But those whose versatility is less, who would suffer a greater diminution in incomes by turning to other lines than by meeting a part or all of the tax, will be likely to remain, largely, in the industry in which they were engaged before the tax was levied. How far the tax will be a burden upon these entrepreneurs in the form of decreased money incomes and how far it will be shifted upon consumers in a higher price of the commodity taxed will depend, in great degree, upon the number of the entrepreneurs in this line who can easily and with little sacrifice change to other lines of production.

The reason here advanced for the conclusion that a tax on commodities may fall in part upon entrepreneurs' profits needs to be especially emphasized since it is not quite the reason currently given. The difficulty is in the concept of the "marginal" employer. The marginal employer is not necessarily the least efficient, an employer who makes next to nothing and lives largely at the expense of his friends, as Walker argues,[1] or the employer who lives by letting his capital depreciate, as Professor Seligman argues.[2] Such an employer may indeed be marginal between entrepreneurship and clerkship; but a very inefficient entrepreneur, if he would be still less efficient in a different capacity, is not marginal. For the present purpose, an entrepreneur's marginality is to be defined as Professor Davenport defines it.[3] In Professor Davenport's view, even the most efficient entrepreneur in any line, if he would be equally efficient (at the prevailing relation of prices) in some other line and would like the latter equally well, is marginal as between these two lines. No discussion of the theory of tax

[1] *Political Economy*, advanced course (New York: Holt, 1887), p. 239.

[2] *The Shifting and Incidence of Taxation*, third edition (New York: Columbia University Press, 1910), p. 235.

[3] *The Economics of Enterprise* (New York: Macmillan, 1913), pp. 73 and 77–82. Cf. the writer's *The Theory of Earned and Unearned Incomes* (Columbia, Missouri: Missouri Book Co., 1918), pp. 13 and 70.

incidence is entirely satisfactory which fails to take account of this view of marginality, since, if a tax in any way whatever contributes to diminish supply, it tends to raise prices.

It is seldom argued that a tax on a specific commodity may rest in part upon the wage-earners engaged in producing that commodity, as distinguished from the wage-earners who are consumers of it. Yet the theory of the shifting and incidence of taxation is not complete until a place has been made in it for this possibility also. For wage-earners, like entrepreneurs, differ in versatility, in capacity, and in taste. And it is at least conceivable that the wage-earners engaged in producing a given commodity may be in large part so relatively ill capacitated for or ill disposed toward other work that they can afford to bear the tax, or will prefer to bear the tax, in lower wages rather than to change to other occupations.

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